

BACKGROUND PAPER FOR HEARING JANUARY 7, 2004

CALIFORNIA BOARD OF ACCOUNTANCY

IDENTIFIED ISSUES, QUESTIONS FOR THE BOARD, BACKGROUND CONCERNING ISSUES, AND RECOMMENDATIONS

PRIOR SUNSET REVIEW: The California Board of Accountancy (Board) was last reviewed by the Joint Legislative Sunset Review Committee (JLSRC) three years ago (2000-01). The JLSRC and the Department of Consumer Affairs (Department) identified a number of issues, along with the Board, and agreed to the following changes to the Accountancy Licensing Act: (1) modify existing examination, education and experience requirements for certified public accountants (CPAs); (2) establish new education, examination and experience requirements to conform to the national Uniform Accountancy Act (UAA); (3) review implementation of the new licensing requirements at the next sunset review; (4) create a peer review process for medium and large accounting firms that wish to provide attest (audit) services; and, extend the sunset date of the Board to July 1, 2006, so that it would be reviewed once again in four years (2004). SB 133 (Statutes of 2001, Chapter 718) implemented all of the changes agreed upon by the JLSRC, the Department and the Board.

The year 2002 saw the accounting profession propelled into the public's eye in an unprecedented manner due to the Enron audit failure and subsequent other major audit failures of several corporations, and the illegal and horrific acts of accountancy firms who were ultimately responsible for providing those audits. The tragic results of those audit failures was the loss of massive sums of investor dollars and the erosion of investor confidence in the marketplace – especially in the work of independent auditors and their audit reports. According to the Board, it was clear that immediate and sustained change was critical, and it was equally evident that California had to take a strong leadership role not only to pursue legislative reform in this state but also to exert influence at the national and federal levels.

In the midst of a global crisis of confidence because of these corporate failures, the Legislature enacted a series of reforms that dramatically changed the regulation of the profession. Many of these reforms were originally discussed and proposed by Board members, staff, the Center for Public Interest Law and the Attorney General's Office. AB 270 (Statutes of 2002, Chapter 231), AB 2873 (Statutes of 2002, Chapter 230) and AB 2930 (Statutes of 2002, Chapter 232) implemented the following changes to the Accountancy Licensing Act: (1) changed the composition of the Board to a public majority; (2) required reporting of specified events by a CPA including restatements of audits, civil actions and judgments, notice of investigations by the Securities and Exchange Commission (SEC); (3) specified that unprofessional conduct of a licensee shall include repeated negligent acts and any disciplinary action taken by the SEC or the national Public Accounting Oversight Board; (4) expanded the enforcement powers of the Board to investigate any violations of state or federal laws or rules pertaining to the practice of accountancy; (5) required the Board to report to the Legislature by September 1, 2003, on problems with policing and disciplining accountants who work for large firms

and on implementation of peer review requirements for CPAs; and, (6) changed the date for the next sunset review to the fall of 2003, so that the reports submitted by the Board could be considered.

On September 2003, the Board submitted its required reports to the JLSRC. They include:

- Report on Problems with Respect to the Policing and Disciplining of Accountants Employed by a Large Public Accounting Firm (Section 5109.5 of the Business and Professions Code).
- Report on Review of Implementation of New Licensing Requirements (Section 5000 of the Business and Professions Code).
- Report on Review of Peer Review Requirements (Section 5076 of the Business and Professions Code).

The following are findings and recommendations of the Board regarding each issue addressed in its reports. The Board will provide a brief overview of its findings and recommendations during the hearing. It will also address an additional issue that has come to the attention of the JLSRC regarding outsourcing of tax preparation work by accounting firms to foreign countries. The Board intends to further investigate this issue and make recommendations to the JLSRC sometime early next year.

REPORT ON DISCIPLINING LARGE PUBLIC ACCOUNTING FIRMS

ISSUE #1: Findings and recommendations of the Board with respect to the policing and disciplining of accountants employed by large public accounting firms.

Question #1 For The Board: *Please provide a brief overview of the Board's findings and recommendations regarding the disciplining of accountants who work for large public accounting firms and the problems encountered by the Board in investigating and prosecuting these types of cases.*

Findings of the Board: The Board is unique in California insofar as it regulates both individuals and firms. The largest firms, known as the "Big Four," are not just some of the largest firms in this state and the United States, but in the entire world. In addition to the Big Four, a significant group of mid-size firms also exists. In their global offices, Big Four and mid-size firms may employ CPAs licensed by 54 U.S. jurisdictions as well as individuals licensed by other countries.

Oversight of large firms, including individuals employed by those firms, presents considerable challenges in budgeting and funding for the extensive, ever-fluctuating investigative and legal resources required to pursue large matters. These barriers are compounded by a cumbersome state contracting process, the necessary acquisition and retention of outside legal resources and technical accounting expertise, lengthy legal procedural timelines, and the consumption of significant internal staff time in meeting all of the requirements of the state's administrative processes and procedures.

Confirming and proving an "audit failure" by a large firm is a rigorous undertaking, and investigations of complex audit engagements can consume several years and cost the Board millions of dollars. To meet the challenges of pursuing large matters, the Board needs a technically proficient

staff of Investigative CPAs (ICPAs), ready access to technical consultants on complex accounting issues, and outside legal counsel. In the present disciplinary structure, no action exists between probation (and attendant terms) and license suspension/revocation. The current disciplinary model provides for probation on one margin of the spectrum and suspension/revocation on the other end. To address this concern, the Board is evaluating whether to establish disciplinary fining authority to be assessed in addition to any other penalties or sanctions against audit firms. The Board would need to seek the necessary authority to impose those sanctions as warranted. It expects to have a recommendation regarding this issue by November 1, 2003.

The Board's annual Enforcement Program budget for complex case matters is approximately \$2 million. Because this amount is appropriated annually, but not always expended, any portion of this \$2 million not spent during the budget year cannot be held over for the next year. However, when a large matter occurs, generating the extreme funding demands that such a case requires, \$2 million can be spent quickly in pursuing a single case. Under current spending authority restrictions, present resource limitations would preclude or severely hamper the Board from actively investigating and prosecuting more than one large firm case at a time.

Given the complex technical accounting issues that arise in large firm cases, it is critical that the Board's enforcement staff include a sufficient number of ICPAs who are skilled in both accounting and the nuances of enforcement. Currently, due to the hiring freeze and budget control provisions, the Board has an insufficient number of qualified ICPAs to pursue multiple large firm matters and simultaneously handle the increased workload created by reform legislation.

Board Recommendations: To address the core challenges to policing large firms and achieve the full benefit of the reform legislation, the Board indicates that it is critical for it to obtain multi-year funding flexibility for complex enforcement matters and the ability to hire and retain a sufficient number of qualified ICPAs. The Board made the following recommendations:

1. OBTAIN FUNDING FLEXIBILITY.

- Seek legislation to afford the ability to trigger access to \$2 million in necessary funds in a given budget year should those fiscal resources be required to continue pursuing one or more complex enforcement matters.
- Seek statutory authority to encumber funds for specific investigative contracts to span at least a 24-month period.
- Seek an increase to its maximum fund reserve to an amount equal to nine months' operating budget, and to prohibit these funds from being used for other than Board fund purposes.

2. HIRE AND RETAIN SUFFICIENT AND QUALIFIED ICPA STAFF.

- Seek reinstatement of the terminated ICPA position with a budget change proposal (BCP) to be initiated for fiscal year 2004-2005, at the request of the State and Consumer Services Agency.
- Seek creation of three new ICPA positions to review new, expanded reportable events information, initiate investigations where determined appropriate, and to liaison with national and federal entities relative to their investigative activities and development of professional

standards. A BCP toward this effort will be initiated for fiscal year 2004-2005, at the request of the State and Consumer Services Agency.

- Continue to seek the establishment of reasonable salary parity for the ICPA classification.

ISSUE #2. Should the Board be granted fining authority to be assessed against large accounting firms for violations of the Accountancy Act?

Question #2 For The Board: *Has the Board reached a decision about whether it should be granted fining authority against large accounting firms? If so, please explain why the Board believes this additional fining authority should be granted by the Legislature.*

REPORT ON IMPLEMENTATION OF NEW LICENSING REQUIREMENTS

ISSUE #3. Findings and recommendations of the Board with respect to implementing new licensing requirements that went into effect on January 1, 2002.

Question #3 For The Board: *Please provide a brief overview of the Board's findings and recommendation with respect to implementing the new licensing requirements that went into effect on January 1, 2002, and any additional actions the Board intends to take regarding licensing requirements for accountants (e.g., adopting "substantial equivalency" standards under the Uniform Accountancy Act).*

Findings of the Board: The statutory changes that became effective on January 1, 2002, have resulted in significant changes to the education, examination, and experience requirements for licensure as a CPA. Most significantly, California now allows for obtaining a CPA license without satisfying an audit experience requirement. Previously, there was only one path to licensure; however, California applicants currently can choose from three pathway options for licensure.

While the new pathways provided applicants various options for becoming California licensees, the implementation efforts to put the new pathway system in place created heavy demands on the Board's limited resources and resulted in significant workload increases in all areas of the Board's Licensing Division. The inability to address this increased workload was exacerbated by the initiation of the statewide hiring freeze in October 2001.

The consequences of the staff reductions coupled with the workload boost are increased delays in processing licensure applications, renewal applications, certifications of exam, and licensure information to other parties, as well as slower responses to e-mails and telephone calls. In fact, time frames for processing applications for licensure, certification and license renewal will continue to be longer than those in existence when the Board was completely staffed, and the changes in licensing requirements had not yet been enacted. If the current circumstances continue, the Board may be unable to comply with its regulatory time frames for processing applications.

Board Recommendation: The new licensure requirements have only been recently implemented, and the Board will administer its last paper-and-pencil CPA exam in November 2003. As a result, it is difficult to predict at this time what long-term staffing and other resources will be required for the Board to effectively and efficiently perform its licensing functions. Therefore, the Board recommends issuing a follow-up, supplemental report at an appropriate time in the future, when adequate data is available, should the Board conclude that additional staffing or funding are required.

REPORT ON FUTURE PEER REVIEW REQUIREMENTS FOR ACCOUNTANTS

ISSUE #4: Findings and recommendation of the Board regarding whether it is necessary to implement a mandatory peer review program in California for accountants.

Question #4 for the Board: *Please provide a brief overview of the Board's findings and recommendation with respect to implementing a mandatory peer review program for accountants in California.*

Findings of the Board: Current law requires the Board to determine whether there is a need to implement a mandatory peer review program in California because of recent changes in federal laws, state statutes and regulations, and professional standards, and to submit a report of its findings to the Legislature.

Late in 2002, the Board established its Peer Review Task Force (PRTF), comprised of four CPAs and three public members. It held two public meetings in 2003, and it reviewed and studied all information related to peer review, including all state and federal statutory reforms, history of peer review in California, passage and implications of the federal Sarbanes-Oxley Act, implementation of the Public Company Accounting Oversight Board (PCAOB), status of proposed changes to the American Institute of Certified Public Accountants' (AICPA) peer review program, and other related subjects. The task force remains in effect, with work still to be accomplished. In evaluating a mandatory peer review program, the PRTF investigated three issues that require significant additional information not yet available:

- a. Inspection requirements for non-public company audits.
- b. The level of risk posed by firms' auditing non-public companies, and
- c. The AICPA's review standards, which are being finalized.

Board Recommendation: Because federal and state statutory and regulatory changes recently took effect and are still in the process of being implemented, and proposed revisions to the national peer review standards have not been finalized, insufficient information is available to determine whether a mandatory peer review program in California is necessary. As a result, the Board has provided this interim report and it recommends that the final report to the Legislature be assigned a due date of September 1, 2005, with a peer review implementation date of July 1, 2008, should a mandatory peer review or inspection program be mandated.

OUTSOURCING OF ACCOUNTING SERVICES

ISSUE #5: Accounting firms are currently outsourcing tax preparation, as well as other accounting and financing services, to other foreign countries and it is unclear what security and disclosure requirements are currently required to assure clients that they are informed about outsourcing of their financial information and that their financial data is protected.

Question #5 for the Board: *Please explain what action the Board is taking regarding the outsourcing of accounting services.*

Background: It has come to the attention of the JLSRC that accounting firms and independent CPAs are utilizing the services of companies that are outsourcing tax preparation work, as well as other accounting and financing services, to India where the actual work is performed and then returned to the firm or CPA once completed. This includes sending all financial data, including bank and brokerage account numbers, and social security numbers of their clients. It is unknown what privacy, security and disclosure requirements are currently required by these companies outsourcing the accounting work, or for the firms or the individual CPA. According to a recent article in a San Francisco paper, few clients are probably aware – or are being informed by CPAs – that their sensitive tax documents may be spanning the globe. What is alarming is that the national association for CPAs, AICPA, seems to endorse this new practice of outsourcing accounting services without discussing any of the problems that may be associated with this practice. In a recent article by AICPA, they indicated that “outsourcing, some observers believe, is the wave of the future for its ability to reduce the time staffers spend on returns and also dramatically reduce the need to hire temporary staff during tax season.” AICPA discusses the advantages of outsourcing, cost savings, etc., and the names of the companies providing outsourcing on behalf of accounting firms and CPAs and how they operate.

With concerns expressed about the potential for identity theft and other financial fraud that could be committed once documents are sent overseas, and whether or not there are real controls on the distribution of this personal financial information, and whether the client is even aware of this practice, it would seem appropriate that the Board investigate this new accounting practice being utilized by CPAs and whether there are certain privacy protections and disclosure requirements that need to be implemented by the Legislature.